

## Military Compensation: Balancing Cash and Noncash Benefits

To attract and retain the military personnel that it needs, the Department of Defense (DoD) must offer a compensation package that is competitive with those in the civilian sector and that adequately rewards service members for the rigors of military life. The Congressional Budget Office (CBO) estimates that in 2002 (the most recent year for which comprehensive data are available), the average active-duty service member received a compensation package worth about \$99,000.

Noncash compensation represents almost 60 percent of the military pay package. Cash compensation—basic pay, allowances for things like food and housing, special pay and bonuses, and the tax advantage that service members receive because some allowances are not subject to federal income tax—makes up the other 40 percent (*see Figure 1*).

About 40 percent of noncash compensation consists of subsidized goods and services that can be used immediately—such as medical care, groceries, housing, and child care. The remaining 60 percent of noncash compensation is the accrued cost of retirement pensions and other deferred benefits that service members receive after they leave active duty—including health care for retirees and veterans' benefits.<sup>1</sup> Yet only about one-third of officers and 10 to 15 percent of enlisted personnel serve the 20 years needed to retire.

This issue brief provides an overview of the military compensation package and the issues surrounding the current mix of compensation. The military's traditional use of noncash benefits reflects, in part, a belief that such benefits are cost-effective because they support unit cohesion

and reduce the costs that service members incur in searching for new schools, stores, and housing as they move among installations. However, today's military increasingly emphasizes a more expeditionary force—deploying service members overseas without their families for a shorter period of time rather than rotating members and families to and from overseas garrisons for extended tours. Therefore, some analysts believe that a compensation package more heavily weighted toward cash, which would allow service members to choose the goods and services that they valued most, would enable DoD to maintain a larger and even more capable force for the same total cost.

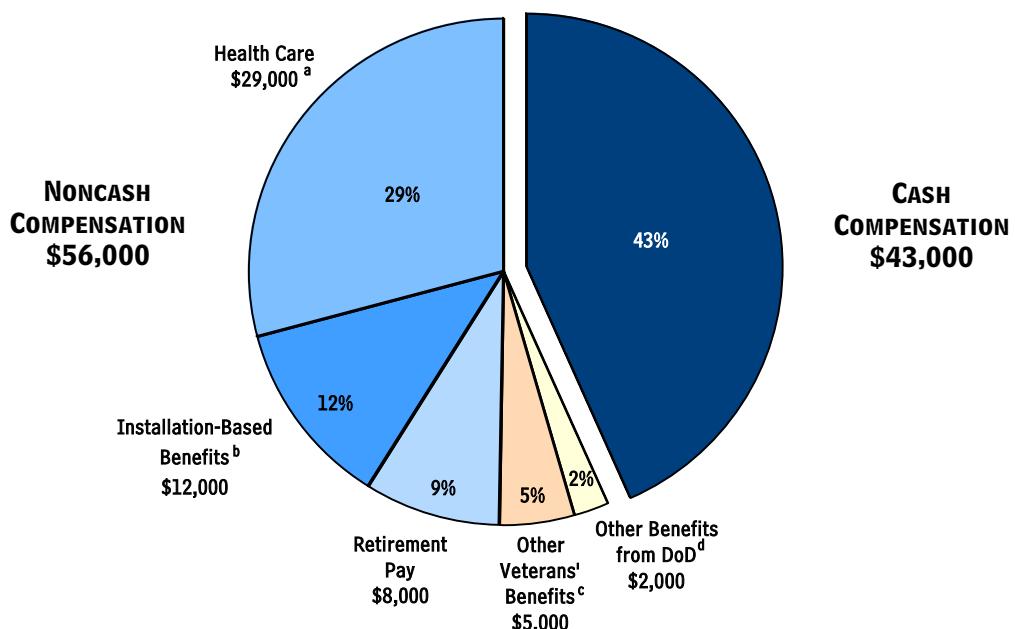
At present, the federal budget does not display the total cost of military personnel or show the distribution of that total cost among its different components. Policymakers may therefore find it difficult to evaluate the size of the compensation package or the implications of changing the mix of cash and noncash elements. For example, some recent policy initiatives—including allowing some disabled retirees to receive both full retirement pay and tax-free disability compensation—have shifted the overall mix of compensation further toward noncash and deferred benefits. Other policy initiatives, such as expanding health care coverage for reservists, have shifted the mix for that component of the service as well.

### The Current Level of and Trends in Noncash Compensation

In 2002, noncash benefits for military personnel totaled \$78 billion, CBO estimates, or about \$56,000 per active-duty service member. Noncash benefits include primarily health care, installation-based benefits, retirement pay, and veterans' benefits.

1. About half of that deferred noncash compensation goes to veterans when they leave the military before retirement, and about half goes to veterans who reach retirement.

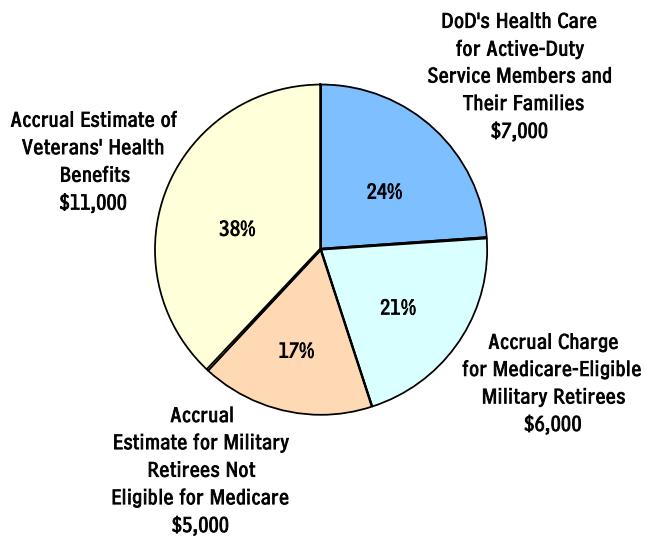
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**Figure 1.****Cash and Noncash Compensation per Active-Duty Member****AVERAGE COMPENSATION IN 2002 = \$99,000**

Source: Congressional Budget Office based on data from the Department of Defense and the Office of Management and Budget.

Notes: This figure includes compensation that service members receive while on active duty and the estimated accrued cost of deferred compensation. Estimated accrual costs, which do not match the current funding for some programs, are based on information in *The Budget of the United States Government, Fiscal Year 2000* (p. 172) and background data and updated information provided by the Office of Management and Budget.

- a. Health care benefits include DoD's funding for active-duty service members and their dependents, as well as estimated accrual costs for current members who will retire and those who may receive care from the Veterans Administration.
- b. Installation-based benefits include subsidized in-kind goods and services found on military installations, such as commissaries, family and bachelor housing, and child care.
- c. Other veterans' benefits include disability compensation, education benefits under the Montgomery G.I. Bill, home mortgage assistance and other loans, vocational rehabilitation and counseling, pension benefits, and burial benefits.
- d. Other benefits from DoD include its contributions to Social Security's Old-Age and Survivors Insurance and Disability Insurance programs, Medicare's Hospital Insurance program, and the Unemployment Compensation for Ex-Servicemen program.

**Figure 2.****Health Care Benefits per Active-Duty Member****AVERAGE BENEFITS IN 2002 = \$29,000**

Source: Congressional Budget Office based on data from the Department of Defense and the Office of Management and Budget.

Notes: This figure includes the accrual charge paid by DoD to cover the future cost of DoD's health care for those service members who retire and are eligible for Medicare, as well as CBO's estimate of the accrual cost of health care for those retirees who are not eligible for Medicare (generally those under 65 years of age) and CBO's estimate of the cost of the medical benefits that members may receive when they leave active duty. Because the health care costs of veterans and younger retirees are not funded on an accrual basis, the estimates cannot be compared with amounts in fiscal year 2002 budget documents.

Because accrual funding of a new benefit for Medicare-eligible retirees was not implemented until 2003, CBO's estimates of DoD's health care funding for fiscal year 2002 are based on fiscal year 2003 funding, reduced for inflation.

**Health Care**

Health care, the largest component of noncash compensation, amounts to approximately \$29,000 per active-duty service member, or nearly 30 percent of the average compensation in 2002 (see Figure 2).<sup>2</sup> The federal government spends (or accrues liabilities of) almost \$40 billion annually for military health care. About \$9 billion per year funds the care of active-duty service members and their families. In addition, the federal government

accrues annual liabilities of roughly \$14 billion to pay for the medical expenses of future retirees.<sup>3</sup>

Military members who leave active duty (and become veterans) are also eligible for health care provided by the Department of Veterans Affairs, worth about \$15 billion annually on an accrual basis.

Health care is also the fastest-growing element of military compensation. Between 1988 and 2002, for example, DoD's portion of health care spending per active-duty service member—adjusted for the overall rate of inflation in the economy—tripled, while cash pay per active-duty member increased by 39 percent. Some of that growth in health care spending resulted from legislation in 2000 that eliminated copayments and deductibles for the families of many active-duty personnel. Much of the growth, however, reflects real (inflation-adjusted) increases in health care costs in the economy as a whole, a trend that is expected to continue.<sup>4</sup>

**Installation-Based Benefits**

Installation-based benefits, which cost more than \$16 billion in 2002—or about \$12,000 per active-duty service member—are the second largest component of noncash pay. They include free or subsidized food, housing, education and child care for dependents, and other goods and services routinely found on military installations. Although total spending on these benefits declined from 1988 to 2002, spending per active-duty member increased by 48 percent in real terms. That growth may reflect efforts to improve the quality of life of military personnel, particularly their housing and child care.

2. Details on rising medical costs and changing benefits in DoD's health care system can be found in Congressional Budget Office, *Growth in Medical Spending by the Department of Defense* (September 2003).
3. Because military members can retire in their 40s, DoD serves two distinct groups of retirees: those who are not eligible for Medicare (generally those under 65 years of age) and those who are eligible. DoD's health care for younger retirees is funded through current appropriations, while care for Medicare-eligible retirees is funded on an accrual basis.
4. See Congressional Budget Office, *Growth in Medical Spending by the Department of Defense*.

## Retirement Pay

Service members who leave with 20 or more years on active duty receive an immediate lifetime annuity funded by DoD on an accrual basis. The department contributed \$12 billion to the military retirement fund in 2002—or about \$8,000 per active-duty service member. That contribution has fallen from about \$23 billion in 1988.

Some of that decrease is due to the downsizing of the force. In addition, DoD's board of actuaries lowered the annual accrual charge per military member to reflect a series of relatively low pay raises in the 1990s (lowering projections of future payments to the fund) and relatively high interest earnings on the fund's balances. Accrual charges could increase in the future, though, as a consequence of higher pay raises and lower earnings for the fund.

## Other Veterans' Benefits

Noncash compensation for nonmedical veterans' benefits makes up about 5 percent of average compensation when estimated on an accrual basis. This category includes the military's largest educational benefit, the provisions of the Montgomery GI Bill; disability compensation; and home mortgage assistance, as well as other programs administered by the Department of Veterans Affairs.<sup>5</sup>

## Other Benefits from DoD

Other benefits from DoD are the department's contributions to Social Security's Old-Age and Survivors Insurance and Disability Insurance programs and to Medicare's Hospital Insurance program fund, as well as the department's payments to the Unemployment Compensation for Ex-Servicemen program. Those programs constitute 2 percent of average compensation.

## Issues Surrounding the Mix of Cash and Noncash Compensation

Opinions vary about whether a military system in which noncash benefits account for almost 60 percent of total compensation is cost-effective or appropriate, particularly when compared with civilian compensation, in which

noncash benefits make up between 20 and 35 percent of the total.

## Views Supporting Noncash Benefits

Those who advocate a compensation package favoring noncash benefits point out that it provides unique benefits to the military by:

- Promoting military readiness;
- Ensuring a good quality of life for young service members;
- Attracting and retaining service members at a lower cost than cash compensation; and
- Providing a stable form of compensation.

**Promotes Military Readiness.** Subsidized physical fitness centers can contribute directly to military readiness by encouraging physical training. Programs that support families—such as subsidized child care or family housing—promote readiness indirectly, as deployed service members who feel that their families are taken care of may perform their jobs more effectively. Moreover, quality-of-life programs that encourage experienced people to remain in the military or that attract high-quality recruits could be said to enhance readiness.

**Ensures Quality of Life.** To offer a good quality of life for service members, DoD establishes standards for some of its in-kind benefits, particularly family housing and child care. Ninety-six percent of DoD's child care centers are accredited, for example, whereas just 8 percent of private child care centers are.<sup>6</sup>

**Costs Less.** Noncash benefits can be cost-effective if the employer can provide goods and services for less than it would cost individual employees to purchase the items themselves. Because group health insurance policies can pool risks, for example, employer-provided health insurance is generally cheaper than individually purchased policies. DoD may similarly be able to offer goods, such as housing, in isolated locations where markets are too thin to support private-sector suppliers. The availability of relatively uniform goods and services, including housing, at

5. Veterans' benefits are not taxable, but the magnitude of that tax advantage has not been estimated for this issue brief.

6. Gail L. Zellman and Susan M. Gates, *Examining the Cost of Military Child Care* (Santa Monica, Calif.: RAND, 2002), p. 11.

military bases throughout the world also reduces the search costs that frequent moves impose on military families.

**Provides Stable Compensation.** Noncash benefits can be more cost-effective than cash payments if service members perceive them as more permanent than cash. If members think cash allowances will substitute for future pay raises, for example, they would value an in-kind benefit more highly.

### Views Supporting Cash Benefits

Many analysts question the extent of the military's reliance on noncash benefits and believe that a greater emphasis on cash would be more efficient for several reasons:

- The value of cash is more easily recognized by potential recruits, current military members deciding whether to reenlist, and senior decisionmakers.
- Cash makes individuals better off by giving them more choices in how they spend their compensation.
- Changes in forces and doctrines have made the current system favoring noncash compensation less effective.

**Easily Recognized Value.** If potential recruits and experienced service members do not recognize the full value of the benefits package, enlistments and retention will be lower than they might be otherwise. People deciding whether to join or continue in the military might compare military and civilian cash pay without taking into account the full value of the military's noncash and deferred benefits. For example, potential recruits and younger service members may greatly discount the 60 percent of noncash compensation that is deferred (such as payments from a retirement plan in which members are vested only after 20 years of service). Thus, a system relying more on cash could provide a larger, more stable force for the same money.<sup>7</sup> Finally, it is difficult for policymakers and senior decisionmakers—in the role of “employers”—to assess the adequacy of total compensation when much of it is provided through noncash benefits.

**Greater Choice.** Cash pay is more efficient than noncash compensation in an economic sense because cash provides employees maximum discretion in how they spend their compensation. In general, because cash gives

people more control over their spending choices, people value in-kind benefits less than cash.<sup>8</sup> For example, proponents of a more cash-based system would favor a pay package with relatively lower benefit costs or cash allowances that service members could use to purchase child care, physical training, groceries, and other commodities from any provider.

### Diminished Effectiveness of the Current System.

Critics of the current system argue that it is rooted in a Cold War strategy that required service members and their families to rotate between the United States and permanent bases overseas. They also note that cash can be more easily targeted to those members who are most productive or who possess special skills that DoD most wants to retain. If today's more expeditionary force allows families to remain in the United States and to develop roots in civilian communities, DoD's efforts to ease the impact of family moves by providing on-base towns with subsidized housing, shopping, schools, and child care may no longer be needed. In addition, installation-based benefits favor active-duty service members living on-base. The two-thirds of active-duty members, plus the reservists, who live off-base may prefer benefits that are not tied to specific locations.

### Shaping the Future Mix of Cash and Noncash Compensation

Further increases in the share of noncash benefits in military compensation could occur. For example, if DoD's future health care spending rises at the same rate as that projected for per capita health care costs in the United States as a whole, for example, the department's health care spending, adjusted for inflation, will increase from

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7. One study found that the vast majority of military members had a strong preference for current versus deferred compensation. Their perspectives indicated discount rates of at least 18 percent; that is, they perceived \$1 received next year to be worth, at most, about 85 cents ( $\$1/(1.18)$ ) today. Such a discount rate would mean that new recruits value \$1 received after 20 years of service at only 4 cents. See John T. Warner and Saul Pleeter, “The Personal Discount Rate: Evidence from Military Downsizing Programs,” *American Economic Review*, vol. 91, no. 1 (2001), pp. 33-53.
8. For greater detail, see N. Gregory Mankiw, *Principles of Economics* (Fort Worth, Tex.: Dryden Press, 1998), p. 469.

its 2003 level of \$27 billion to almost \$46 billion in 2020, CBO estimates.<sup>9</sup>

Noncash compensation could also grow as DoD and the Congress seek to respond to the changing needs of the force. For example, costs could grow if any of the following policies, all of which have been considered by the Congress or proposed by advocacy groups, were implemented:

- Further expanding access to DoD's health care system for reservists and their dependents;
- Further expanding reservists' access to subsidized on-base activities; or
- Further expanding veterans' benefits, including eliminating the provision that offsets recipients' retirement pay when they receive disability compensation.

Some types of noncash compensation can offer unique advantages to the military. But even when cash compensation is more efficient, changing the current mix to emphasize cash compensation or forestalling further increases in noncash benefits can be difficult for several reasons.

Noncash benefits are hard to quantify because they come in many forms and are funded from many different budget accounts. For example, part of the subsidized housing program is funded through cash allowances, which are included in the military personnel appropriation, while the construction and maintenance of on-base housing are funded from other appropriations to DoD.

Noncash benefits often develop diverse constituencies. In the case of commissaries, for example, the American Logistics Association—a voluntary nonprofit organization of manufacturers, brokers, distributors, and other companies that provide goods and services to the military resale system—has a mission “to promote, protect, and ensure the existence and continued viability of the military resale systems....”<sup>10</sup>

9. Congressional Budget Office, *Growth in Medical Spending by the Department of Defense*.

10. See [www.ala-national.org/HomePage/about.html](http://www.ala-national.org/HomePage/about.html).

Finally, substituting cash for noncash benefits is difficult because the switch could prove costly in the near term, even though it would save money eventually. For example, to avoid charges of inequity, switching to a cash allowance system could require payments to all eligible beneficiaries, and not just to those who currently use a particular benefit.

## Options to Increase the Share of Cash Relative to Noncash Compensation

Analysts have frequently explored the economic and budgetary implications of options that could increase the military's reliance on cash payments and reduce its reliance on noncash benefits.<sup>11</sup> Options examined by CBO include these:

### Offer Medical “Cafeteria Plans”

To give service members greater choice about the form of their health care benefits, DoD could offer medical “cafeteria plans.” The idea is modeled on trends in the private sector, where some employers have made their compensation systems more flexible by letting employees choose among several different types of noncash benefits and cash. In its 2003 *Budget Options* volume, CBO included an option that would establish a medical cafeteria plan to give active-duty service members the choice between cash compensation and a generous medical insurance plan with few copayments and deductibles. While all active-duty members must receive care within the military's health care system, members would receive a cash allowance for family coverage that they could use to:

- Purchase the current level of coverage for their families (which would entail low copayments and deductibles);
- Purchase a lower level of coverage and keep the extra cash; or

11. See, for example, Richard Buddin and others, *An Evaluation of Housing Options for Military Families* (Santa Monica, Calif.: RAND, 1999); Beth J. Asch, Richard Johnson, and John T. Warner, *Reforming the Military Retirement System* (Santa Monica, Calif.: RAND, 1998); Glenn Ackerman and others, *Housing Benefits: Baseline Analysis* (Alexandria, Va.: Center for Naval Analyses, 1997); and National Defense Panel, *Transforming Defense: National Security in the 21st Century* (December 1997).

- Purchase other insurance (perhaps through a spouse's employer or other means).

CBO estimated that the net savings in fiscal year 2004 would be \$18 million, rising to \$185 million in 2006 as the program was fully implemented. By fiscal year 2020, savings could rise to \$245 million annually. Because active-duty personnel and their families would choose the level of coverage that they wanted, recruiting and retention and the quality of the force could improve.

### Offer Cash Allowances

A related option would gradually substitute allowances in place of in-kind benefits. In its 2003 *Budget Options*, CBO examined an option in which commissaries and exchanges would be consolidated to eliminate duplicate functions, and eligible families would receive tax-free grocery allowances of about \$500 per year. Under that system, the federal government could save \$550 million a year, CBO estimated.

### Incorporate Some Noncash Benefits into the Military Personnel Appropriation

CBO has also examined possibilities for consolidating some personnel-related expenditures—such as those for

commissaries, some medical care, DoD schools, and family housing—into DoD's appropriation for military personnel. Greater visibility would allow senior leaders in DoD and the Congress to more easily assess the total cost of military personnel. Advantages of this option would include improved incentives for DoD managers to use military personnel effectively, encouraging them to substitute less costly civilian employees or contractors or labor-saving technology for military personnel where appropriate. Some of those same advantages might be gained if the Administration's annual budget submission to the Congress were to provide a consolidated display of all federal costs for military personnel for the past fiscal year, estimates for the current year, and requests for the budget year.

**Related CBO Publications:** *Growth in Medical Spending by the Department of Defense* (September 2003); *Budget Options* (March 2003).

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